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Easements in the Wake of Catastrophe: The Legal Fallout

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Easements in the Wake of Catastrophe: The Legal Fallout

by William T. Hutton and Walter T. Moore

On the night of September 21, 1989, Hurricane Hugo wreaked havoc on the city of Charleston. Winds clocked at 135 miles per hour snapped trees, smashed windows and ripped off roofs. Three days later torrential rains compounded the damage, flooding ground floors, pouring through open roofs and ruining interiors.

In the peninsula city looking out toward Fort Sumter in the harbor where Confederate troops fired the first shots of the Civil War in April 1861, about 80 percent of the 3,500 historic buildings, both public and private, sustained some damage. *The Washington Post*, June 14, 1990

Hugo's indiscriminate wrath, visited upon a city where historic preservation is big business, also underscored some sobering economic realities about easement-"protected" properties and raised a host of legal issues that, it is safe to say, land trust and preservation organizations have not greatly explored. Among them:

How should drafters of easements anticipate potential natural disasters?

Who should provide casualty loss insurance coverage and how should insurance proceeds be applied in the event of a casualty loss?

What tax consequences result from a casualty loss to an easement-protected property?

If there are tax benefits resulting from the loss or remaining value in the property after the loss, how should they be allocated?

What provisions should be included in the easement to assure a careful determination of whether the remaining natural or historical values are worth the price of restoration?

What will be the easement holder's respon-

sibilities and/or right to proceeds in the event that sale or release of the easement turns out to be the most sensible course of action?

Fortunately, the economic strength of the Charleston area and the importance of historic properties to its well-being made the choice to restore damaged historic properties relatively clear. That is not always apt to be the case; historic districts in deteriorating urban areas ravaged by flood or fire might well present different economic choices. And it takes no great prescience to project the same concerns upon natural lands subject to easements. Fire, storm, or the more insidious but no less damaging ravages of man might well impair or destroy agricultural, scenic, or habitat values. This article, therefore, is an attempt to consider the issues with which land trusts and their advisors ought to grapple in anticipating potential calamitous events.

The regulatory preconditions—perpetuity and changed conditions

That a conservation or preservation easement must be "granted in perpetuity"—a categorical statutory

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requirement—does not mean that it *must* last forever. The applicable Treasury regulations acknowledge, in fact, that “a subsequent unexpected change in the conditions surrounding the property” may make “impossible or impractical the continued use of the property for conservation purposes.” Treas. Reg. § 1.170A-14(g)(6)(i). And if so, the encumbrance of the easement may be extinguished by a judicial proceeding and the proceeds from sale or exchange of the property may be applied, under the same regulatory mandate, “by the donee organization in the manner consistent with the conservation purposes of the original contribution.”

It should be observed as a threshold matter that the Commissioner of Internal Revenue is unlikely: (a) to intervene in any judicial proceeding in which the land trust seeks in good faith to extinguish an easement in order to set the stage for a disposition of the property; or (b) to meddle in the decision of how the proceeds of such a sale might best be applied. The quoted regulations are, after all, directed to the establishment of a charitable contribution’s validity upon the conveyance of the easement. It is a quite reasonable thing to require that, at the grant of an easement, the donor and donee anticipate the possibility—or perhaps likelihood—that it may last for a very long time. But whether the easement should survive a calamity that seriously impairs or destroys the attributes of the property that it was designed to protect is a decision best left to the judgment of the board and

staff of the land or preservation trust.

The regulations further require that an effective easement include a provision establishing that its fair market value at the time of grant is no less than the “proportionate value that the perpetual conservation restriction...bears to the value of the property as a whole at that time.” Reg. § 1.170A-14(g)(6)(ii). Once determined, the easement value is thereafter deemed to remain a constant percentage, so that upon a change in conditions giving rise to extinguishment, the easement holder is “entitled to a portion of the proceeds at least equal to that proportionate value..., unless state law provides that the donor is entitled to the full proceeds....”

Despite its apparent precision, the “proportionate value” rule—a mandatory easement provision—may have little to do with the actual division of proceeds when an extinguishment of the easement precedes sale of the property. Parties to a contract (and the easement functions in this setting as a bilateral contract) have the right to revisit their bargain. Thus, changed conditions, whether effected by the accretion of small events or a single catastrophe, are likely to bring the landowner and the holder of the easement back to the bargaining table. At that point, in addressing the question “Where do we go from here?”, they are apt to pay very little attention to the now essentially irrelevant dictates of the tax regulations. It would, however, be prudent for their revised contract, prescribing extinguishment of the ease-

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ment and the means of division of the sale proceeds, to be approved by the appropriate judicial authority. Deference to judicial judgment, in a presumably uncontested proceeding, is advisable less because the tax regulations mandate extinguishment by judicial proceeding than because judicial process validates the land trust board's decision, based upon a careful evaluation of post-catastrophe circumstances, to convert the frustrated easement to liquid assets.

In sum, then, the regulatory provisions concerning perpetuity and changed conditions are neither a straightjacket nor a particularly useful guide to conduct. They may set the stage for negotiations, but they are most unlikely to drive a settlement. Most importantly, they do nothing whatsoever to establish mechanisms to ameliorate the economic impact of unforeseen and unpredictable events.

Relevant easement provisions

The possibility that unforeseen events may frustrate the purposes of a conservation easement must be acknowledged and dealt with at the time the easement is negotiated. Since the regulatory test for extinguishment is the impossibility or impracticality of continued use of the property for conservation purposes, the post-catastrophe decision to repair or divest will force a reexamination of the stated premises of the easement. If the easement refers only to a single, narrow purpose (say, protection of a rare or endangered species habitat), the frustration of that purpose may compel a decision to lift the easement despite the ostensible presence of other significant conservation attributes.

That is not to say, of course, that the all-too-typical laundry list of conservation objectives ("to preserve and protect the natural, scenic, open-space, botanical, and biotic diversity elements of the Property") should be mindlessly imported here. An effort should be made to define the essential purposes, in order to provide a framework for the post-calamity decision of whether to apply available resources to repair or restore those described attributes.

As to historic properties, the preservation organization should consider local statutes regulating demolition of historic buildings. Where the damage caused by a natural disaster meets the demolition standards of such a statute (as established by administrative or judicial proceeding), restoration may be beyond the power of the easement holder and the parties will be limited to determining the appropriate allocation of whatever insurance proceeds or remaining value may lurk in the damaged property.

Where no statute governs (as is apt to be the case concerning undeveloped natural properties), the easement document itself will serve as the springboard to

decision. The extent to which the original easement seller or donor and the charitable organization have anticipated the destructive event of process will determine whether the post-disaster decision process is manageable and orderly or chaotic and unpredictable.

Typical easement provisions handle the potential frustration of the easement with provisions like these, from the model easement in *The Conservation Easement Handbook*:

Extinguishment. If circumstances arise in the future such as render the purpose of this Easement impossible to accomplish, this Easement can only be terminated or extinguished, whether in whole or in part, by judicial proceedings in a court of competent jurisdiction, and the amount of the proceeds to which Grantee shall be entitled, after the satisfaction of prior claims, from any sale, exchange, or involuntary conversion of all or any portion of the Property subsequent to such termination or extinguishment, shall be determined, unless otherwise provided by [state] law at the time, in accordance with paragraph []. Grantee shall use all such proceeds in a manner consistent with the conservation purposes of this grant.

Proceeds. This Easement constitutes a real property interest immediately vested in Grantee, which, for the purposes of paragraph [], the parties stipulate to have a fair market value determined by multiplying the fair market value of the Property unencumbered by the Easement (minus any increase in value after the date of this grant attributable to improvements) by the ratio of the value of the Easement at the time of this grant to the value of the Property, without deduction for the value for the Easement, at the time of this grant. The values at the time of this grant shall be those values used to calculate the deduction for federal income tax purposes allowable by reason of this grant, pursuant to Section 170(h) of the Internal Revenue Code of 1986, as amended. For the purposes of this paragraph, the ratio of the value of the Easement to the value of the Property unencumbered by the Easement shall remain constant.

The foregoing beautifully tracks the requirements of the Treasury regulations noted above. They are of little use, however, as guides to conduct. Their principal defect is in their failure to furnish any suggestion of what it takes to meet the "impossibility" standard. It would be a simple matter to set out the circumstances deemed to meet that standard in the event of a natural disaster; for example, the disappearance of a protected species, degradation or loss of top soil so as to render an agricultural property incapable of sustained production, the loss of forest cover, etc.

The model provision also omits reference to "impracticality"—an alternative ground for extinguishment under the regulations. In our view that omission is un-

fortunate. In most cases the "restore-or-sale" decision will involve balancing conservation concerns against available resources. Framing the issue in terms of the possible, instead of the sensible, may quite unnecessarily deprive the parties of the opportunity to make a fair and balanced appraisal. To illustrate, a judicial arbiter might determine that economic considerations are irrelevant so long as it remains possible to maintain some semblance of the easement's protection. Particularly where the parties have made no effort to describe with precision the truly significant conservation and preservation elements, the "impossibility" standard may be very difficult indeed to meet.

Another regulations-based flaw in the "extinguishment" paragraph of the model is in the requirement that "Grantee shall use all such proceeds in a manner consistent with the conservation purposes of this grant." Obviously, if extinguishment is the result, the particular conservation purposes of "this grant" no longer exist. Far better to provide that "all such proceeds shall be used in a manner consistent with the conservation purposes of Grantee." (It will not escape notice that such use of the proceeds and, indeed, all resources of the organization, will be so mandated by charter and the requirements for maintenance of tax-exempt status anyway.)

We commented above upon the fiction that "the ratio of the value of the easement to the value of the property unencumbered by the easement" shall remain constant over the life of the easement. *The Conservation Easement Handbook* acknowledges that the easement value, as a function of the property's overall value, might well go up or down over time and suggests "as a matter of basic fairness" that appreciation due to improvements should be allocated to the possessory interest. But, as noted above, the ratio is apt to have little if any significance beyond establishing the conditions for deductibility at the time of the grant. Thereafter it becomes merely an opening bid in the negotiations over division of proceeds, should extinguishment occur.

Casualty loss Insurance coverage

The need to consider a fair division of proceeds only arises if the parties intend to sell or exchange the property or an involuntary transfer occurs. If appropriate insurance has been maintained that will provide for restoration of the easement, in most cases the property will be restored (the rare exception being where neither economics nor conservation purposes justify such an application of the insurance proceeds). Therefore, a primary drafting challenge involves insurance—its application, coverage, and the possible division of proceeds.

The sole provision for insurance in the *Handbook's* model easement is intended to cover the

costs and liabilities associated with property ownership rather than casualty losses specifically: "Grantors...shall bear all costs and liabilities of any kind related to the ownership, operation, upkeep, and maintenance of the Property, including the maintenance of adequate comprehensive general liability insurance coverage."

There are two dangers in such a provision. First, the clause does not mandate adequate casualty loss coverage—it merely speaks of a "comprehensive general liability insurance coverage." Second, if the grantor is required to maintain the "comprehensive general liability insurance coverage," why, upon a casualty loss, should he or she feel obligated to apply the insurance proceeds to restoration of the easement-protected attributes?

A better provision would obligate the owner to maintain casualty loss coverage for the easement as a distinct part of "comprehensive general insurance coverage." Of course, if the conservation organization requires the landowner to maintain additional insurance to cover the easement adequately, the parties may have to come to an agreement over who should pay the extra costs. The insurance clause, or a collateral provision, should also allow the easement holder to effect restoration at its option in the event that insurance proves inadequate or if casualty insurance coverage is lacking. Finally, the provision should provide a formula for dividing the insurance proceeds. The suggested provision might read as follows:

[]. *Casualty Loss Insurance Coverage.* Grantor shall maintain insurance adequate to restore the Property to its preexisting condition in the event of a casualty loss. Regardless of whether adequate insurance to effect such restoration has been maintained, the decision to effect restoration of the Property will be determined according to paragraph []. In the event that (i) restoration does not occur, (ii) insurance proceeds exceed the cost of restoration, or (iii) the easement is extinguished on account of the impossibility or impracticality of restoring the [conservation, preservation, etc.] attributes of the Property, the division of insurance proceeds shall be determined in accordance with paragraph [].

Tax benefits arising out of casualty loss

For the uninsured or underinsured landowner, federal income tax benefits accruing in respect of casualties may somewhat mitigate the loss occasioned by natural disaster. Determining the extent of that mitigation demands a fundamental understanding of the computation of casualty loss deductions, which, in turn, takes us back to the division of basis which occurred upon the original easement transfer.

Assume, for purposes of illustration, that Zane Sturdley, owner and operator of the historic Thalweg

Rezinski Home for Ancient Mariners, conveyed a facade easement to the Carp Creek Historical Society in 1986. Prior to that conveyance, Zane's basis in the building was \$150,000 and the easement reduced the value of the property from \$375,000 to \$250,000. Under applicable regulations, Zane's basis in the building was apportioned between the easement and the retained fee in accordance with their respective fair market values (i.e., Zane's basis in the retained interest was reduced from \$150,000 to \$100,000). Reg. § 1.170A-14(h)(3)(iii).

Now suppose that, immediately prior to the natural calamity about to be visited upon the Thalweg Rezinski Home, Zane's basis had been further reduced to \$80,000 through depreciation deductions, while the building had appreciated in value to \$300,000. Neither basis, nor value, nor historical significance is of any concern to Hurricane Alfred, which inflicts serious but not terminal damage upon the Home, reducing its value from \$300,000 to \$120,000. Zane, alas, is uninsured.

The measure of Zane's economic damage is \$180,000, or the difference between the fair market value of the property immediately before and immediately after the casualty. But basis puts a cap on Zane's potential casualty loss deduction. Reg. § 1.165-7(b)(1) requires that in the case of any casualty loss, the amount of loss to be taken into account shall be the lesser of: (i) the fair market value of the property immediately before the casualty reduced by the fair market value of the property immediately after (\$180,000, the measure of destruction); or (ii) the amount of the adjusted basis (\$80,000). (Adjusted basis is generally the cost [here the original cost of \$150,000 reduced to \$100,000 upon conveyance of the easement] reduced by depreciation deductions [\$20,000].)

Thus Zane's casualty loss is \$80,000—his adjusted basis in the building. At an assumed Federal marginal rate of 31% (not an entirely safe assumption; see the alternative minimum tax), Zane's casualty loss produces tax benefits of \$24,800. The comparison of that number—essentially a function of his basis in the property and applicable tax rates—with his very real economic loss (\$180,000) reveals the discouraging truth about the significance of government tax subsidies in the casualty context.

The Zane Sturdley story involves a taxpayer who is allowed depreciation deductions on his property because he runs it as a business (the rules are similar for investment properties). But suppose instead that Zane's property were held for residential purposes. In that case, Zane would not have been allowed depreciation on the property and thus his tax benefits on account of the casualty loss would appear to be greater (perhaps 31% of \$100,000).

We say "appear" because casualty losses at-

tributable to personal-use properties (i.e., assets held for neither business nor investment purposes) are subject to two additional computational constraints. First, the casualty loss deduction attributable to a personal-use asset can never exceed *either* the property's adjusted basis *or* the "before and after" measure of damage. Second, and generally more discouraging, net casualty losses to such assets for any year are only permitted to the extent that they exceed 10% of the taxpayer's adjusted gross income. Thus, were Zane's loss to have occurred in a year in which his adjusted gross income were \$120,000, the \$99,900 loss otherwise allowable (every personal-use asset casualty is also subject to a \$100 "floor") would be further reduced to \$87,900 (i.e., by 10% of his adjusted gross income of \$120,000).

What is a "casualty"?

In drafting a provision that calls for application of insurance proceeds and, possibly, tax benefits towards a restoration or distribution obligation, it is crucial to have a fix upon the scope of the statutory concept of "casualty" as applied in interpretation of the Internal Revenue Code's casualty loss allowance provision. The implication from relevant revenue rulings and cases is that a casualty loss must be not only "sudden" in nature (not predictable or avoidable), but also the result of actual physical damage.

The requirement that a casualty loss be sudden is reflected in Revenue Ruling 63-232 (1963-2 C.B. 97):

Damage caused by termites to property not connected with a trade or business does not constitute an allowable deduction as a casualty loss within the meaning of section 165(c)(3) of the Code. Such damage is the result of gradual deterioration through a steadily operating cause and is not the result of an identifiable event of a sudden, unusual or unexpected nature.¹

In addition to requiring that the casualty loss be "sudden," Revenue Ruling 63-232 prescribes that the loss be of an "unusual or unexpected nature." If a casualty is predictable or avoidable, it will probably fail to qualify. For example, applicable regulations that permit a deduction for a casualty loss on account of an automobile accident deny the deduction where the accident is "due to the willful act or willful negligence of the taxpayer or of one acting in his behalf." Reg. § 1.165-7(a)(3).

Although it may seem self-evident, we should also note that a casualty loss must result in physical damage. In *Pulvers v. Commissioner*, 407 F.2d 838 (9th Cir. 1969), a California case, taxpayers attempted to claim a deduction for a casualty loss as a consequence of a mudslide that ruined three nearby homes, but did no physical damage to the property of the taxpayers. The

taxpayers' claim was based upon a substantial and undeniable loss of value because of fear the mountain might attack again. The court rejected this argument on the grounds that "[t]he specific losses named [in the statute] are fire, storm, [and] shipwreck.... Each of those surely involves physical damage.... Thus, we read 'or other casualty,' in *para materia*, meaning 'something like those specifically mentioned.' The first things that one thinks of as 'other casualty losses' are earthquakes and automobile collision losses, both involving physical damage losses."

A potentially significant exception to the statutory definitions of casualty loss and the judicial interpretations of those definitions should also be mentioned. Section 165(k) of the Code allows a taxpayer, whose residence is located in an area determined by the president of the United States to warrant assistance by the federal government under the Disaster Relief and Emergency Assistance Act, to treat any loss attributable to such disaster as a deductible casualty loss if, within 120 days after such presidential determination, the taxpayer is ordered to demolish or relocate such residence and the residence has been rendered unsafe for use by reason of the disaster.

Model provisions—restoration

Assume that property protected by an easement has been damaged or destroyed in a sudden event. There may or may not be insurance proceeds or tax benefits resulting from the destruction. The landowner and the easement holder go back to the negotiating table to determine what to do with the damaged or destroyed property, and the easement, which forms the foundation of their relationship, contains no provision relating to restoration.

The conservation organization may well have conflicting interests in this situation. On the one hand, it may be psychically and politically inclined towards restoration, but restoration simply may not make sense. The conservation value of the property may have been destroyed or the damaged property, while restorable, may not justify the expenditure required to restore it. The organization might reasonably conclude that the best course would be to release the easement. But mere relinquishment of an easement is a risky thing indeed. As the *Handbook* correctly warns, "No nonprofit organization should release an easement on privately held land without receiving adequate compensation. To do so would probably violate state law, be contrary to the purpose for which the organization was formed, and jeopardize the organization's tax-exempt status. The compensation should at least be equal to the increase in the value of the land resulting from the termination of the restrictions." *The Conservation Easement Handbook*

at 133.

The availability of restoration funding is obviously of intense relevance. As seen above, casualty loss insurance coverage and tax benefits arising from a casualty loss are possible sources of funds from which restoration of the easement may be financed. The owners of the historic buildings in Charleston damaged by Hurricane Hugo were also considerably assisted by a third source of restoration funding—special donations. (Disaster funds established by the Historic Charleston Foundation and the Preservation Society of Charleston received over \$600,000 in donations.) In addition, the possibility of foundation and/or government financing should not be ignored.

From our anticipatory perspective, what is needed is an easement provision that will allow the conservation organization either: (i) to restore the property if it is so unique and important that, regardless of the availability of funds, it should be restored; or (ii), at the other extreme, to realize an opportunity to turn an inert, non-productive, and nonessential asset into support for another project without jeopardizing its charitable status.

In no event should the easement holder be prevented from obtaining proceeds resulting from the casualty damage to the conservation or preservation attributes of the property and applying those proceeds in an appropriate manner. Thus, the provision should contain explicit restoration requirements, either free-standing or linked to the availability of insurance or tax benefits, based upon: (i) measurable post-catastrophe value; (ii) economic utility (as to a business or investment property); or (iii) residential viability. The better approach would link the viability test to the availability of insurance, tax benefit, or other resources.

We suggest the following as a working draft:

[]. *Restoration in the Event of Casualty Loss.* If circumstances arise under which the Property incurs a casualty loss (as defined by I.R.C. §165(c)(3)), all casualty loss proceeds, whether from insurance, tax benefits or some other source, resulting from such loss and attributable to destruction of the [conservation, historical, scenic, etc.] attributes of the Property shall be applied to restore those attributes of the Property to their condition immediately preceding the casualty. If the Property's post-casualty value and economic utility [or residential viability] are diminished to an extent which renders such use of the proceeds towards restoration futile or economically impractical, the Grantee shall have the option to terminate or extinguish this Easement in accordance with paragraph []. Exercise by Grantee of the option herein provided shall not be deemed a relinquishment of any claim to the casualty loss proceeds which would have gone towards restoration of the property if Grantee had not exercised such option.

This model provision achieves three objectives. First, it does not allow the easement to be challenged as nonperpetual because the easement is not terminable at the will of the Grantee. Rather, the easement may be extinguished only in the limited circumstance defined in the provision. Second, it requires that all funds resulting from a casualty loss to features protected by the easement must be used towards restoration of those features, yet allows the conservation organization the option, in limited circumstances, to make a realistic assessment of the value of the property after the casualty loss and decide whether the funds could be applied more appropriately and effectively elsewhere. Finally, it provides a framework for the negotiations the landowner and the conservation organization must begin after a catastrophe has hit.

Final considerations

If a lender holds a mortgage on property to be restricted, the Internal Revenue Service requires that its rights be subordinated to the right of the qualified organization to enforce the conservation purposes of the gift. Reg. § 1.170A-14(g)(2). Thus, the lender's interest must be considered in framing effective restoration provisions.

To illustrate, a lender that has agreed to subordinate its lien to the conservation easement (presumably because it believes that there is adequate value or carrying capacity in the property even after the imposition of that easement) can hardly be expected to accede to a provision that allows insurance proceeds first to be applied to restore those conservation, scenic, historical, or other elements that have nothing to do with the value of the property that stands as security for the debt. (Note, in the suggested draft provision above, that the Grantee's claim is limited to proceeds attributable to destruction of the conservation attributes.) The third-party lender will also reasonably object to any restoration provision unless restoring the property makes economic sense.

The *Handbook* suggests that negotiating with the holder of the possessory interest over a price for release of the easement (or, presumably, over division of sales proceeds on disposition of the entire property) is "dangerous and undesirable." In the post-casualty context, however, we take quite a different view. Provided that the board of directors of the conservation or preservation organization is satisfied that fair market value has been realized, it seems irresponsible to suggest that maintenance of a meaningless or low-priority easement—premised, perhaps, on nothing more convincing than the belief in the sanctity of such an interest—should take precedence over more vital projects towards which the proceeds from release or sale of an interest might be directed.

We have attempted to broach some legal and practical considerations that have been largely ignored in structuring easement transactions to date. Reflection and experience will hone the issues and shape the answers. In the meantime, our purpose will have been served if, as a standard agenda item in the easement-negotiation process, the land trust or historic preservation advisor simply asks, "What happens if...?"

Endnote

1. The Internal Revenue Service position on termite losses—an issue apt to be of considerable significance to preservation organizations in moderate climes—is by no means the last word. Where taxpayers have been able to demonstrate rapid destruction over a period not exceeding a year or two, they have prevailed in the courts against the Service's contention that termites are not capable of eating fast enough to satisfy the statute. The message, of course, is that regular inspections may preserve the opportunity to take a casualty loss deduction in response to an invasion of particularly ravenous termites.

William T. Hutton is the director of the Land Conservation Law Institute. Walter T. Moore is a student of Hastings College of the Law and a research editor of The Back Forty.

Congress Enacts Forest Legacy Program

by Peter R. Stein

The Forest Legacy Program (12 C.F.R. § 1217) was enacted by Congress in 1990, authorizing the U.S. Forest Service to initiate a new conservation easement acquisition program. The program is a willing seller effort, with explicit language that the interest in acquired land shall be held solely by the United States of America. While the program initially targets the four Northern Forest Lands Study states (New York, New Hampshire, Vermont, and Maine) and the State of Washington, in fiscal year 1993 the program will become available nationally. As stated in the authorizing legislation, the Secretary of the Department of Agriculture, acting through the U.S. Forest Service, shall:

establish a program, known as the Forest Legacy Program, in cooperation with appropriate state, regional and other units of government for the purposes of ascertaining and protecting environmentally important forest areas that are threatened with conversion to non-forest uses and, through the use of conservation easements and other mechanisms, for promoting forest land protection and other conservation opportunities. Such purposes